

## NETSCAPE's IPO

HOW IS IT POSSIBLE TO OBTAIN A VALUE OF MORE THAN 1 BILLION,  
WHEN THE BOOK VALUE IS \$16 MILLION AND THE COMPANY HAD YET TO  
TURN A PROFIT?

More specifically, at what rate does the company have to grow over the next 10  
years to justify an offer price of \$28? Furthermore, and how much capital is  
initially needed to sustain this growth rate.




### ABSTRACT:

Netscape Communications Corporation was one of the first companies to make the features of Internet easy accessible for old and new customers. The company developed user-friendly software. In the 1990's there was enormous developments of the "IT"-industry, a knowledge based industry. New "dot.com" companies were introduced at an accelerating speed.

In these companies the most important asset is human capital. All goods sold are dependent on the way they improve or ease the work of the customers. All such companies are priced on expectations. Investors had enormous expectations to this industry in the 1990's. That's why the underwriters suggested an IPO-price that valued the company to more than \$1billion. In the first trading day the market valued the company more than twice the IPO -value.

Given additional assumptions and by analysing Netscape's income statement and balance sheet for Dec 31 -94 and Jun 30-95, we found that the company had to grow by 36-39% over the next 10 years to justify an offer price of \$28. At this growth rate To Furthermore, we



Based on the financial data available, Morgan Stanley came up with a price of \$12 - \$14 per share. This value was based on the future prospects of Netscape and the Internet industry in general. Furthermore, the analysis was built on the financial and operating information about Netscape and its competitors.

### Analysis

The valuation process is basically comprised of two steps. (1) A 10-year forecast of the financial performance of Netscape. (2) Calculating a terminal value. To arrive at reasonable estimate of the value of Netscape, we need to make specific

assumptions about the firm's operations. These assumptions are primarily based on the historical performance of Netscape and its competitors. As an example, we used the  $\beta_{Microsoft}$  as a proxy for  $\beta_{Netscape}$  in a CAPM framework to obtain the required rate of return on the Netscape stock. The capital structure of these two companies differs slightly. The debt-to-value ratio of Microsoft was zero in 1995. Since the debt-to-value of Netscape was less than 5% in 1995 and fell rapidly as a function of time, we found that differences were insignificant. At the same time we also have to recognize that there is uncertainty associated with this estimate. One of the key questions of this analysis was to assess the company growth and how this growth is related to Netscape's needs of additional funding. Dependent on the growth rate in revenues, it is quite obvious that Netscape urgently needs additional funds to further finance its future operations. Based on our model and zero growth rate in revenues, we find that within the next three years (1995 - 1998), about \$20 million is needed to finance continued operations. Not surprisingly, this figure increases significantly at higher growth rates. For a yearly growth rate of 30% in revenues the corresponding figure is \$38 million. The explanation for these observations is quite obvious. Since capital expenditures are a function of total revenues, an increase in revenues will lead to an increase in capital expenditures. This in turn increases the need for further financing. Moreover, since the fraction of capital expenditures relative to total revenues is quite high in the period 1995 - 1998, we find that the level of retained earnings is not sufficient to sustain support the growth in capital expenditure.

The main results of our model generally indicate that a growth rate of 36% - 39% over a 10-year period is needed to justify a share price of value of \$28. An assumption in the model is that the growth rate is constant over the entire 10 - year forecasting period. A more realistic scenario could be a growth rate of 60% - 70% in the first three years, the blooming period, and then declining towards a 4% growth after 2005.

There are several shortcomings of the valuation approach presented here. First, the calculated terminal value, which represents a relatively large fraction of overall company value, is particularly sensitive to small changes in the market assumption from which the value is derived. Secondly, it was noted that the share price was quite sensitive changes in the growth rate.